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REPLY TO
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AZ CORP COMMISSION
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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF US WEST COMMUNICATION, INC. A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES	DOCKET NO. T-01051B-99-0105

Arizona Corporation Commission
DOCKETED
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NOTICE OF FILING

Enclosed for filing are an original and ten(10) copies of the Surrebuttal Testimony of Richard B. Lee, and Surrebuttal Testimony of Charles W. King, on behalf of the United States Department of Defense and All Other Federal Executive Agencies, in the above referenced proceeding.

Copies have been served on all known parties in accordance with the enclosed Service List.

Respectfully submitted this 7th day of September, 2000.

Sincerely,

PETER Q. NYCE, JR.
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Enclosure

ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

2000 SEP -8 A 11: 35

AZ CORP COMMISSION
DOCUMENT CONTROL

CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
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Commissioner

IN THE MATTER OF THE APPLICATION OF U S WEST COMMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN	**DOCKET NO. T-01051B-99-0105**

SURREBUTTAL TESTIMONY
of
RICHARD B. LEE

on behalf of

THE UNITED STATES DEPARTMENT OF DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES

ROBERT N. KITTEL, CHIEF
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by

Peter Q. Nyce, Jr.
General Attorney

September 8, 2000

Surrebuttal Testimony of Richard B. Lee

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INTRODUCTION

Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

A. My name is Richard B. Lee. I am Vice President of the economic consulting firm of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). My business address is 1220 L Street, N.W., Suite 410, Washington, D.C. 20005.

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS DOCKET?

A. I am appearing on behalf of the Department of Defense and all other Federal Executive Agencies ("DOD/FEA").

Q. ARE YOU THE SAME RICHARD B. LEE WHO SUBMITTED DIRECT TESTIMONY IN THIS PROCEEDING ON JULY 25, 2000?

A. Yes, I am.

Q. DID YOUR DIRECT TESTIMONY CONTAIN A DESCRIPTION OF YOUR BACKGROUND AND EXPERIENCE?

A. Yes, it did.

Q. WAS THIS TESTIMONY PREPARED BY YOU OR UNDER YOUR DIRECT SUPERVISION?

A. Yes, it was.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. In this surrebuttal testimony, I will respond to the rebuttal testimony of QWEST witnesses George Redding, Kerry Dennis Wu and Ann Koehler-Christensen.

Q. PLEASE SUMMARIZE YOUR FINDINGS.

A. Most of the criticisms of my Direct Testimony are without merit. In my Direct Testimony I proposed seven adjustments which had the effect of changing Qwest's revenue requirement deficiency of $201.2 million to an excess of $46.9 million.[1] My review of the Rebuttal Testimonies filed by Qwest and the Direct Testimonies of other parties has led me to revise certain adjustments and add an eighth adjustment. I now calculate Qwest's revenue excess to be $52 million.

TEST PERIOD THEORY

Q. WHAT IS A TEST PERIOD?

A. A "test period" is a snapshot of a regulated company's financial performance for use in determining the company's revenue requirement.

Q. WHAT TYPE OF TEST PERIODS HAVE REGULATORS USED IN DEVELOPING REVENUE REQUIREMENTS?

A. Regulators have generally used either "historic", "fully forecast", or "partially forecast" test periods.

Q. PLEASE DESCRIBE AN HISTORIC TEST PERIOD.

A. An historic test period is one for which all financial data is available. Its advantage lies in the reviewable nature of this data. It requires adjustment,

[1] Lee Direct, p. 4.

however, for use in ratemaking. First, it must be adjusted to accurately reflect only the revenues and expenses relevant to the period in question. Mr. Redding refers to such adjustments as "accounting" adjustments.[2] Second, it may need to be adjusted to reflect conditions expected during the first year of new rates. In general, the use of an historic test period assumes that revenues and costs will change over time in a consistent manner such that the company's rate of return will remain constant. If there are specific conditions which can be expected to be upset this consistency, they can be accommodated by adjustments to the historic test period. Mr. Redding refers to such adjustments as "pro forma" adjustments.[3]

This proceeding is based upon an historic test period of December 31, 1999.

Q. PLEASE DESCRIBE A FULLY FORECAST TEST PERIOD.

A. A fully forecast test period is for a future period for which no financial data is available. Its advantage lies in that it requires no accounting adjustments and, if the period chosen is the first year of new rates, no pro forma adjustments. It can be just as contentious as an historic test period, however, since it is based entirely upon future estimates.

[2] Redding Rebuttal, p. 6.

[3] Id., p. 7.

Q. PLEASE DESCRIBE A PARTIALLY FORECAST TEST PERIOD.

A. As the name implies, a partially forecast test period consists of some months for which financial data is available, and some months which are fully forecast. It shares the strengths and weakness of both the historic and fully forecast test periods.

Q. WHAT ARE "COMMISSION" ADJUSTMENTS?

A. Commission adjustments is the term Mr. Redding uses to refer to adjustments made by the Commission in prior rate cases.[4] Such adjustments can be made to any type of test period, and reflect decisions made by a Commission to impute or disallow revenues, expenses or investment in determining revenue requirements. I will use the term "policy" adjustments in this testimony to include both past Commission adjustments and proposed imputations or disallowances.

Q. DO YOU AGREE WITH MR. REDDING'S DEFINITION OF THE PURPOSE OF THE TEST PERIOD?

A. Mr. Redding describes the purpose of the test period twice. On Page 4 he states:

> The purpose of the test period is to estimate, to the best extent possible, the conditions that will exist when rates from this proceeding will go into effect.

This definition is appropriate only for fully estimated test periods. It is likely that all financial data (revenues, expenses and investment) will differ greatly from an

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[4] Id., p. 6.

historical test period by the time rates go into effect.

Mr. Redding's other description of the purpose of the test period is almost correct. On page i of his Summary he states:

> The purpose of any properly adjusted test period is to produce a revenue requirement that will allow the Company the opportunity to achieve the requested rate of return in the future when rates from the proceeding will be in effect.

I take issue with only the use of word "requested' instead of "allowed" when referring to the rate of return. The appropriate target rate of return is a contentious issue in this proceeding, as in most rate cases.

Q. IS MR. REDDING'S COMPARISON OF ADJUSTED RATES OF RETURN ON PAGE 9 OF HIS REBUTTAL TESTIMONY RELEVANT TO THIS PROCEEDING?

A. No. Mr. Redding annualizes booked financial data for the first five months of 2000 and adjusts this data by the net operating income value of the revenue requirement he calculates to determine an adjusted rate of return. He performs that same calculation based upon the proposed revenue requirements of the Commission Staff ("Staff") and the Residential Utility Consumer Office ("RUCO"). He then compares this data to the rate of return proposed by each party.

In effect, Mr. Redding is introducing a new partially forecast test period (5 months actual, 7 months estimated). For it to be relevant at all, this period would require accounting adjustments to normalize the first 5 months and various pro forma adjustments. It is entirely too late in this proceeding to start all over again with a new test period.

Furthermore, Mr. Redding's analysis is grossly misleading on its face because it ignores policy adjustments proposed by the parties. For example, both Staff and RUCO propose a continuation of the $43 million directory advertising revenue imputation which has been in effect for the past sixteen years. To be relevant to this proceeding, any comparison to booked data would have to reflect such policy imputations and disallowances.

But even if Mr. Redding's calculations were somehow revised to reflect accounting, pro forma and policy adjustments, it would still not be relevant to the question of which revenue requirement calculation is correct as of the historical test period ended December 31, 1999. This is because a properly adjusted test period provides the Company with only the opportunity to earn the allowed rate of return, not a guarantee.

Financial bookings beyond the test period reflect actual input price changes, achieved productivity levels and a myriad of management decisions affecting expenses and investments. Absent significant exogenous factors, achieved returns can be described as the result of the relative growth in input prices and productivity. If input price increases exceed productivity gains, returns go down. If productivity gains exceed input price increases, returns go up. A comparison of financial bookings beyond a test period to test period calculations sheds little light on the appropriateness of test period adjustments.

Ironically, Qwest itself disavowed such calculations nearly a year ago. On December 13, 1999, DOD/FEA requested revenue data for months beyond the then test period of June 30, 1998.[5] Qwest objected to this request on December 21, 1999. Qwest stated:

> US WEST objects to Information Request DOD/FEA 3-1 on the grounds that it is not reasonably calculated to lead to the discovery of admissible evidence and that it calls for information significantly outside of the test-year established in this matter.[6]

DOD/FEA did not pursue its request for all of the reasons discussed above. Financial bookings beyond the test period simply are not relevant to the determination of a Company's test period revenue requirement.

ADJUSTMENT 1 – CUSTOMER OPERATIONS EXPENSE

ADJUSTMENT 2 – CORPORATE OPERATIONS EXPENSE

Q. DOES QWEST ACCEPT YOUR FIRST TWO ADJUSTMENTS?

A. No. In my Direct Testimony I proposed test period revenue requirement reductions of $20.5 million for customer operations expense and $11.7 million for corporate operations expense.[7] Mr. Redding had based his revenue

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[5] DOD/FEA Information Request 3-1(See Attachment 7).

[6] Qwest, Objections to Department of Defense's Third Set of Information Requests to U S WEST Communications, Inc., p. 1 (See Attachment 8).

[7] Lee Direct, pp. 5-7.

requirement calculation on a five month trend of expenses from October 1999 to February 2000. I based my calculation on the trend of customer and corporate operations expenses from <u>January 1997 through December 1999</u>.[8] Mr. Redding contends that my adjustment relies on "old history".

Ironically (again), Mr. Redding attempts to discredit my calculation by reference to a trend chart he prepared of Expenses Other than Depreciation from <u>January 1997 through May 2000</u>. His reliance on "old history" is, of course, as appropriate as mine. Thirty-six months of history provides a sound basis for trending expenses. His conclusion, however, that my specific adjustments to customer and corporate expenses are somehow invalidated by his charting of total expenses is incorrect. As discussed above, and as Qwest contended last year, financial bookings beyond the test period are irrelevant to the determination of appropriate historical test period adjustments. My calculation accurately shows the going-basis level of customer and corporate operations expenses as of the test period, December 31, 1999.

<u>ADJUSTMENT 3 – SERVICES DEREGULATED BY FCC</u>

Q. DOES QWEST ACCEPT YOUR THIRD ADJUSTMENT?

A. Not exactly. In my Direct Testimony, I proposed a test period revenue

[8] My specific adjustments were calculated as of the end of December 1999 to coincide with the historical test period in this proceeding.

requirement reduction of $13 million which I believed was half of the test period loss on services deregulated by the Federal Communications Commission ("FCC"). This is the treatment afforded such services by the Commission in the last rate case.

Mr. Redding believes such services should be specifically deregulated by the Commission and removed completely from the test period.[9] If the Commission deregulates these services, I agree that their impact should be completely removed from the test period. If the Commission does not deregulate these services, I believe half of any gains or losses should be removed from the test period.

I find, however, that my calculation as submitted is in error. In an information request, DOD/FEA asked for a break-out of all revenue, expense and rate base amounts included in the test year, but considered nonregulated by the FCC.[10] U S WEST's response provided me with the data for all services considered nonregulated by the FCC, including those not included in the test year. On Attachment 1 to this Surrebuttal Testimony I have revised my third adjustment to reflect the removal of half of the losses for only those services included in the test period. The revised revenue requirement reduction is $2.4 million as shown on Page 2 of Attachment 1.

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[9] Redding Rebuttal, pp. 45-46.

[10] Information Request DOD/FEA 4-7.

ADJUSTMENT 4 – DIRECTORY ADVERTISING

Q. DOES QWEST ACCEPT YOUR FOURTH ADJUSTMENT?

A. No. In my Direct Testimony, I proposed a test period revenue requirement reduction of $42.7 million to reflect the long-standing imputation of directory advertising revenues in the determination of intrastate revenue requirements.[11] This policy adjustment is based upon the decision of the court to transfer the directory function to the Bell Operating Companies in 1984 so that the significant profits of this operation would continue to be used to reduce local telephone rates.

Ms. Koehler-Christensen contends that a 1988 settlement agreement between Mountain Bell and the Commission dictate that the fees and value of services received by Qwest from DEX are to be the basis for any directory imputation.[12] She relies upon the following part of the settlement agreement:

> [T]he Commission, in arriving at the test year operating income of Mountain Bell, will consider the fees and the value of services received by Mountain Bell from USWD under publishing agreements with USWD; that Mountain Bell and the Commission Staff may present evidence in support of or in contradiction to those fees and the value of those services.[13]

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[11] Lee Direct, pp. 8-10.

[12] Koehler-Christensen Rebuttal, p. 18.

[13] Id., Page i (emphasis added).

She than proceeds to detail the fees and the value of service received by Qwest from DEX, and concludes that no additional revenue imputation is appropriate.[14]

There is a fatal flaw in Ms. Koehler-Christensen's logic. While the Commission must consider the fees and value of services received by Qwest from DEX, the basis for imputation is the value of the directory function transferred to DEX. For over a decade, this value has been $43 million. For example, if a publishing fee of $20 million were to be received by Qwest from DEX, the Commission would be obligated to consider this fee and reduce the $43 million imputation accordingly. Absent such publishing fee, the imputation must continue.

Ms. Koehler-Christensen does, however, correctly note that I failed to remove $1.7 million in fees that were actually received by Qwest from DEX from the $43 million imputation. Attachment 2 to this Surrebuttal Testimony revises my calculation of Adjustment 4 to correct this omission, and shows a revised revenue requirement reduction of $41.3 million.

ADJUSTMENT 5 – PRODUCTIVITY

Q. DOES QWEST ACCEPT YOUR FIFTH ADJUSTMENT?

A. Mr. Redding appears to accept the concept of a productivity adjustment, but he

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[14] Id., p. 11.

contends that I am applying it in a "mechanical manner."[15] He once again supports his opposition to my adjustment by *reference* to financial bookings beyond the test period. He states:

> As shown on Rebuttal Exhibit GAR-R2, Expenses Other Than Depreciation, the pro forma level of these expenses proposed by the Company exactly matches the levels of actual expenses as of May 2000. This pro forma level of expenses includes the full value of the out of period wage increases with <u>no productivity</u> offset. Had the Company's pro forma level been higher than actual May 2000, expenses, then a reevaluation of that pro forma level might have been appropriate.[16]

Mr. Redding's argument should be rejected.

As discussed at length above, actual financial bookings beyond the test period can be affected by many factors and are irrelevant to the appropriateness of test period adjustments. My productivity adjustment of 3.5 percent was based upon Qwest's average productivity for the five year period ending 1998.[17] My adjustment is based upon the concept that, if the Commission allows adjustment for input price increases beyond the test period, as proposed by Mr. Redding, it must also allow an adjustment for expected productivity improvement beyond the

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15 Redding Rebuttal, p. 57.

16 Id. (emphasis added).

17 Lee Direct, p. 11.

test period. To do otherwise would be to bias the revenue requirement calculation improperly.

Conceptually, if Qwest continues to achieve average productivity gains beyond the test period, it will achieve the rate of return targeted in this proceeding. If its productivity is above average, its achieved return will be above the target. If its productivity is below average, its achieved return will be below the target.

Even if we assume that Mr. Redding's calculations demonstrate that Qwest's <u>actual</u> productivity for the first five months of 2000 has dropped to zero, my test period adjustment remains appropriate. The Commission should expect no less than average productivity from Qwest. The rejection of my productivity adjustment would effectively reward Qwest for a decrease in its productivity.

Mr. Redding has updated his productivity calculation to include 1999 data.[18] The average productivity for the five year period ending 1999 remains 3.5 percent, so there is no need for a revision to my originally filed productivity adjustment.

[18] 1999 productivity was 3.6 percent. Qwest Response to UTI 60-15.

ADJUSTMENT 6 – DEPRECIATION

Q. DOES QWEST ACCEPT YOUR SIXTH ADJUSTMENT?

A. No. Mr. Wu contends that my adjustment is inconsistent with the Commission's depreciation orders.[19] He states that the effect of my adjustment is a write-off of investment and a denial of capital recovery on that investment. He states that such a writeoff proposal was rejected by the Commission in Decision No. 62507.

My sixth adjustment proposed a revenue requirement reduction of $109 million based upon the use of depreciation rates incorporating the depreciation lives adopted by the Commission in Docket No. 62507.[20] Mr. Wu does not dispute this fact. He does, however, protest my calculations, which assume that rates based upon these lives would be effective as of the study date used by Mr. Wu to develop rates (1/1/97). While conceding that the FCC requires that depreciation rates be calculated effective as of the study date, he contends that such an assumption should not be adopted in this proceeding since (1) the depreciation order was dated three and a half years after the study date, and (2) the Commission can legally ignore the FCC's policy.[21]

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19 Wu Rebuttal, p. 4.

20 Attachment 3 to this Surrebuttal Testimony revises Adjustment 6 to incorporate technical corrections in accordance with Qwest's response to WDA 34-9. This revision results in a revised revenue requirement reduction of $110 million.

21 Id., p. 5.

Mr. Wu is correct in noting that the FCC leaves it to the states to decide when intrastate depreciation rates will become effective for state ratemaking purposes. The Commission should use this discretion to assume that the lives it adopted were effective as of the study date in this proceeding.

The depreciation lives adopted by the Commission in Docket No. 62507 are very short. The depreciation rates calculated by Mr. Wu as of 1/1/97 are very high, because depreciation reserve levels as of 1/1/97 were relatively low. Unless these rates are assumed to be effective (for ratemaking purposes) as of 1/1/97, Qwest's revenue requirement as of December 31, 1999, test period will combine high depreciation rates with high net book costs. As I noted in my Direct Testimony, this is precisely the result that the FCC found would disadvantage consumers and competitors.[22]

The FCC requires carriers to write-down its investment before it will prescribe depreciation lives as short as this Commission has approved. The Commission need not require Qwest to write-off its investment to ensure just and reasonable rates. The Commission need only adopt the ratemaking adjustment I have proposed. If it accepts my adjustment, Qwest's revenue requirement will reflect an appropriate level of depreciation accruals.

If my adjustment is not adopted, the level of depreciation accruals in

[22] Lee Direct, p. 14.

Qwest's revenue requirement will be excessive. The Supreme Court has found that excessive depreciation represents, in effect, capital contributions paid by subscribers.[23] The Commission is not empowered to require telephone subscribers to contribute capital to finance Qwest's operations.

Q. HAVE YOU REVIEWED STAFF'S POSITION ON DEPRECIATION?

A. Yes, I have. William Dunkel's Direct Testimony provides an alternative to my proposal which should be adopted if my proposal is rejected.

First, Mr. Dunkel ameliorates the problem of very short depreciation lives in combination with high net book costs by calculating rates as of the test period (December 31, 1999) using the lives adopted by the Commission and the depreciation reserve level as of December 31, 1999.[24] If this adjustment is adopted, Qwest should be required to revise its regulatory books to reflect these rates.[25]

Second, Mr. Dunkel proposes a rate credit if Qwest's plant retirements do not materialize as implied by the very short lives adopted by the Commission. In effect, I view this mechanism as giving Qwest the "benefit of a doubt" in

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[23] Lindheimer v. Illinois Bell Telephone Co., 292 U.S. 151, 78 L. ed 1182, 54 S. Ct. 658 (1934).

[24] For the Analog Switching account, Mr. Dunkel used the rate calculated by Mr. Wu as of 1/1/97. In effect, this implies a 3.4 year life, which would be appropriate for a "dying" account amortization pursuant to established FCC practices.

[25] The Analog Switching account should reflect a 3.4 percent year amortization.

establishing its revenue requirement. If Qwest does indeed experience an "avalanche" of retirements in the next few years, its short depreciation lives will be justified. In this case, the higher rates paid by subscribers will not included a capital contribution. If these retirements do <u>not</u> materialize, the high depreciation rates <u>will</u> represent a capital contribution, and Qwest should be required to return its excess recoveries to ratepayers in the form of a billing credit.

ADJUSTMENT 7 – RATE OF RETURN

Q. DOES QWEST ACCEPT YOUR SEVENTH ADJUSTMENT?

A. No. In his Surrebuttal Testimony, DOD/FEA witness Charles W. King addresses Qwest's rebuttal testimony on the subject of rate of return.

Q. DO YOU HAVE A REVISION TO ADJUSTMENT 7?

A. Yes, I do. My revisions to Adjustments 3 and 6 require a conforming revision to Adjustment 7. I have shown this revision on Attachment 4 to this Surrebuttal Testimony.

ADJUSTMENT 8 – REVENUES

Q. HAS MR. REDDING'S REBUTTAL TESTIMONY LED YOU TO PROPOSE AN EIGHTH REVENUE REQUIREMENT ADJUSTMENT?

A. Yes. Mr. Redding presents a chart trending intrastate revenues since January 1997. On Page 1 of Attachment 5 to this Surrebuttal Testimony I have determined the revenue level as of the test period, December 31, 1999, based upon the trend of intrastate revenues from January 1997 through December 1999. This is the same trending methodology I used to develop Adjustments 1 and 2 as discussed above.

On Page 3 of Attachment 5, I compare this revenue level to that proposed by Mr. Redding for the test period and determine that Mr. Redding has overstated test period revenues by $15 million. On Page 4 of Attachment 5, I calculate a revenue requirement reduction of $15 million as Adjustment 8.

CONCLUSION

Q. HAVE YOU PREPARED A SUMMARY OF YOUR PROPOSED REVENUE REQUIREMENT ADJUSTMENTS?

A. Yes. Attachment 6 to this Surrebuttal Testimony provides a summary of my proposed adjustments, including the revisions discussed above. As shown in Column j, I calculate a Qwest test period revenue excess of $52 million.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

DOD/FEA Test Year Adjustment 3
Services Deregulated By FCC
$(000)

		FCC Deregulated Services (a)	1/2 FCC Deregulated Services (b = a / 2)
1.	Revenues	85,479	42,739
2.	Expenses	86,748	43,374
3.	Rate Base	18,914	9,457

Source: Col. a = Staff Direct, Schedule C-17

DOD/FEA Test Year Adjustment 3
Services Deregulated By FCC
$(000)

Operating Revenue	(42,739)
Operating Expenses	(43,374)
Total Operating Income Taxes	255
Net Operating Income	380
Rate Base	(9,457)
Revenue Requirements	(2,398)

This adjustment reflects half of the impact of services deregulated by the FCC on the test year.

Attachment 2

DOD/FEA Test Year Adjustment 4
Directory Advertising
$(000)

Operating Revenue	41,340
Operating Expenses	808
Total Operating Income Taxes	16,294
Net Operating Income	24,238
Rate Base	-
Revenue Requirements	(41,340)

This adjustment imputes directory advertising revenue to the test year.

DOD/FEA TEST YEAR ADJUSTMENT 6
DEPRECIATION
($000)

Account Number	Account Name or Subclass of Plant	Intrastate Investment 12/31/99 (a)	Change In Accruals Annual (b)	Change In Accruals 3 Year (c=3*b)	12/31/99 Reserve (d)	Adjusted Reserve (e=c+d)	Reserve Percent (f=e/a)
2112	Motor Vehicles	47,502	(2,308)	(6,924)	34,912	27,988	58.9%
2114	Spec Purpose Vehicles	18	1	3	0	3	16.7%
2115	Garage Work Equipment	961	90	270	(684)	(414)	-43.1%
2116	Other Work Equipment	15,891	1,851	5,553	2,269	7,822	49.2%
2121	Buildings	115,383	(476)	(1,428)	39,573	38,145	33.1%
2122	Furniture	1,208	174	522	(20)	502	41.6%
2123.1	Ofc. Support Eqpt	3,883	610	1,830	1,649	3,479	89.6%
2123.2	Company Communications Eqpt	1,040	(728)	(2,184)	1,594	(590)	-56.7%
2124	Gen. Purpose Computers	79,409	(10,237)	(30,711)	67,857	37,146	46.8%
2211	Analog Switching Equipment	110,824	16,400	49,200	47,604	96,804	87.3%
2212	Digital Switching Equipment	655,053	15,529	46,587	278,255	324,842	49.6%
2220	Operator Systems	6,498	0 *	0	4,187	4,187	64.4%
2231	Radio Systems	23,571	(895)	(2,685)	19,450	16,765	71.1%
2232.1	Circuit DDS	5,667	(663)	(1,989)	6,006	4,017	70.9%
2232.2	Circuit Digital	752,751	6,040	18,120	395,804	413,924	55.0%
2232.3	Circuit Analog	32,631	(3,906)	(11,718)	31,098	19,380	59.4%
2362	Other Terminal Equipment	40,092	(1,000)	(3,000)	21,273	18,273	45.6%
2411	Pole Lines	34,403	125	375	27,203	27,578	80.2%
2421.1	Aerial Cable - Metallic	121,417	2,419	7,257	94,889	102,146	84.1%
2421.2	Aerial Cable - Nonmetallic	4,563	33	99	1,303	1,402	30.7%
2422.1	Underground Cable - Metallic	257,054	7,936	23,808	160,771	184,579	71.8%
2422.2	Underground Cable - Nonmetallic	64,194	2,310	6,930	24,788	31,718	49.4%
2423.1	Buried Cable - Metallic	927,241	50,736	152,208	414,376	566,584	61.1%
2423.2	Buried Cable - Nonmetallic	12,727	171	513	4,860	5,373	42.2%
2424.1	Submarine Cable - Metallic	2	2	0	0	0	-
2424.2	Submarine Cable - Nonmetallic	0	0	0	0	0	-
2426.1	Intrabldg Cable - Metallic	30,275	(197)	(591)	22,912	22,321	73.7%
2426.2	Intrabldg Cable - Nonmetallic	429	3	9	177	186	43.4%
2431	Aerial Wire	6,494	504	1,512	2,117	3,629	55.9%
2441	Conduit Systems	225,140	401	1,203	54,795	55,998	24.9%
	Total	3,576,321	84,925	254,769	1,759,018	2,013,787	56.3%

Source: Col. a = Wu Testimony, 5/3/00, Exhibit KDW-2, p.1, Col A.
Col. b = Wu Testimony, 5/3/00, Exhibit KDW-1, p.4, Col P.
Col. d = Response to WDA 21-001, Attachment D.

* Assumes no accruals since 1/1/97.

DOD/FEA TEST YEAR ADJUSTMENT 6
DEPRECIATION
($000)

Account Number	Account Name or Subclass of Plan	Reserve Percent (a)	Future Net Salvage Percent (b)	Average Remaining Life (c)	Remaining Life Rate (d= (100-a-b)/c)	Intrastate Investment 12/31/99 (e)	Test Period Accruals (f=d*e)
2112	Motor Vehicles	58.9%	16%	3.9	6.4%	47,502	3,040
2114	Spec Purpose Vehicles	16.7%	0%	7.3	11.4%	18	2
2115	Garage Work Equipment	-43.1%	-4%	9.7	15.2%	961	146
2116	Other Work Equipment	49.2%	7%	5.7	7.7%	15,891	1,224
2121	Buildings	33.1%	-6%	25.0	2.9%	115,383	3,346
2122	Furniture	41.6%	0%	4.8	12.2%	1,208	147
2123.1	Ofc. Support Eqpt	89.6%	0%	3.0	3.5%	3,883	136
2123.2	Company Communications Eqpt	-56.7%	0%	3.7	42.4%	1,040	441
2124	Gen. Purpose Computers	46.8%	5%	2.1	23.0%	79,409	18,264
2211	Analog Switching Equipment	87.3%	0%	*	*	110,824	14,020
2212	Digital Switching Equipment	49.6%	3%	5.1	9.3%	655,053	60,920
2220	Operator Systems	64.4%	-3%	5.2	7.4%	6,498	481
2231	Radio Systems	71.1%	-2%	5.9	5.2%	23,571	1,226
2232.1	Circuit DDS	70.9%	3%	3.8	6.9%	5,667	391
2232.2	Circuit Digital	55.0%	2%	5.1	8.4%	752,751	63,231
2232.3	Circuit Analog	59.4%	0%	3.1	13.1%	32,631	4,275
2362	Other Terminal Equipment	45.6%	2%	6.3	8.3%	40,092	3,328
2411	Pole Lines	80.2%	-138%	25.0	6.3%	34,403	2,167
2421.1	Aerial Cable - Metallic	84.1%	-27%	5.1	8.4%	121,417	10,199
2421.2	Aerial Cable - Nonmetallic	30.7%	-27%	10.6	9.1%	4,563	415
2422.1	Underground Cable - Metallic	71.8%	-6%	5.6	6.1%	257,054	15,680
2422.2	Underground Cable - Nonmetallic	49.4%	-6%	6.0	9.4%	64,194	6,034
2423.1	Buried Cable - Metallic	61.1%	-7%	5.6	8.2%	927,241	76,034
2423.2	Buried Cable - Nonmetallic	42.2%	-7%	10.2	6.4%	12,727	815
2424.1	Submarine Cable - Metallic	0.0%	0%	0.5	200.0%	2	4
2424.2	Submarine Cable - Nonmetallic	0.0%	0%	0.0	0.0%	0	0
2426.1	Intrabldg Cable - Metallic	73.7%	0%	7.7	3.4%	30,275	1,029
2426.2	Intrabldg Cable - Nonmetallic	43.4%	0%	6.2	9.1%	429	39
2431	Aerial Wire	55.9%	-30%	5.6	13.2%	6,494	857
2441	Conduit Systems	24.9%	-20%	41.0	2.3%	225,140	5,178
	Total					3,576,321	293,069
	US WEST (Wu Testimony, Exhibit KDW-2, p.1, Col. E)						355,134
	Adjustment						(62,065)

Source: Col. a = Attachment 3, p. 1.
Col. b = Wu Testimony, 5/3/00, Exhibit KDW-1, p.5, Cols E & G.
Col. c = Responses to WDA 21-151 and WDA 34-9.

* AYFR = Year 2000 (Accruals = Investment - Reserve)

DOD/FEA TEST YEAR ADJUSTMENT 6
DEPRECIATION
($000)

Operating Revenues	0
Operating Expenses	(62,065)
Total Operating Income Taxes	24,950
Net Operating Income	37,115
Rate Base	(254,769)
Revenue Requirements	(110,491)

This adjustment revises U S West's estimate of the end of period depreciation expense and rate base.

DOD/FEA Test Year Adjustment 7
Rate of Return
$(000)

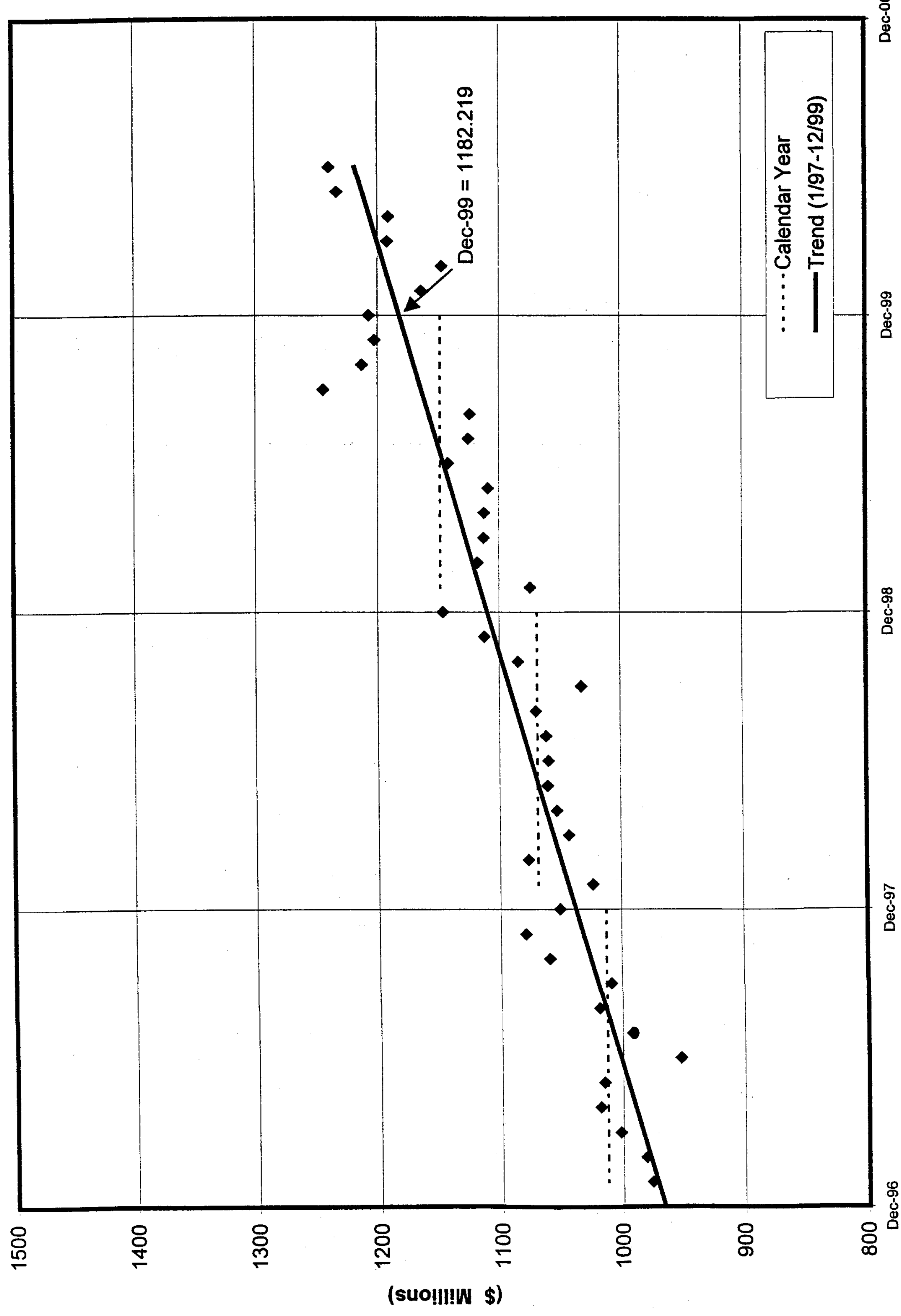
1.	U S WEST Rate of Return (GAR-S1)	10.86%
2.	DOD/FEA Rate of Return (King Testimony)	9.54%
3.	Reduction to Rate of Return (L1 - L2)	1.32%
4.	Adjusted Rate Base (Attachment 6)	$1,157,873
5.	Reduction in Required Earnings (L3 x L4)	$15,284

DOD/FEA Test Year Adjustment 7
Rate of Return
$(000)

Operating Revenue	-
Operating Expenses	-
Total Operating Income Taxes	-
Net Operating Income	15,284
Rate Base	-
Revenue Requirements	(26,068)

This adjustment reflects a 9.54 percent required rate of return.

Annualized Intrastate Revenues



Intrastate Revenue Trend Data

YR / MO	Gross Revenue a	Directory Surcharge b	Adjusted Month c = a - b	Annualized d = 12c	Annualized (for graph)	Annualized 2000 (for graph)
Jan-97	81,316,314	-	81,316,314	975,795,768	976	
Feb-97	81,745,162	-	81,745,162	980,941,944	981	
Mar-97	83,531,574	-	83,531,574	1,002,378,888	1,002	
Apr-97	84,900,707	-	84,900,707	1,018,808,484	1,019	
May-97	84,629,780	-	84,629,780	1,015,557,360	1,016	
Jun-97	79,342,313	-	79,342,313	952,107,756	952	
Jul-97	82,677,190	-	82,677,190	992,126,280	992	
Aug-97	84,927,610	-	84,927,610	1,019,131,320	1,019	
Sep-97	84,078,843	-	84,078,843	1,008,946,116	1,009	
Oct-97	89,927,786	1,598,225	88,329,561	1,059,954,732	1,060	
Nov-97	91,564,060	1,598,225	89,965,835	1,079,590,020	1,080	
Dec-97	89,184,545	1,598,225	87,586,320	1,051,035,840	1,051	
Jan-98	86,903,075	1,598,225	85,304,850	1,023,658,200	1,024	
Feb-98	91,346,481	1,598,225	89,748,256	1,076,979,072	1,077	
Mar-98	88,543,754	1,598,225	86,945,529	1,043,346,348	1,043	
Apr-98	89,367,062	1,598,225	87,768,837	1,053,226,044	1,053	
May-98	89,978,983	1,598,225	88,380,758	1,060,569,096	1,061	
Jun-98	89,928,370	1,598,225	88,330,145	1,059,961,740	1,060	
Jul-98	90,083,599	1,598,225	88,485,374	1,061,824,488	1,062	
Aug-98	90,775,917	1,598,225	89,177,692	1,070,132,304	1,070	
Sep-98	87,633,301	1,598,225	86,035,076	1,032,420,912	1,032	
Oct-98	92,004,659	1,598,225	90,406,434	1,084,877,208	1,085	
Nov-98	94,306,705	1,598,225	92,708,480	1,112,501,760	1,113	
Dec-98	97,161,319	1,598,225	95,563,094	1,146,757,128	1,147	
Jan-99	91,138,000	1,598,225	89,539,775	1,074,477,300	1,074	
Feb-99	94,764,000	1,598,225	93,165,775	1,117,989,300	1,118	
Mar-99	94,349,000	1,598,225	92,750,775	1,113,009,300	1,113	
Apr-99	94,320,000	1,598,225	92,721,775	1,112,661,300	1,113	
May-99	94,053,000	1,598,225	92,454,775	1,109,457,300	1,109	
Jun-99	96,803,000	1,598,225	95,204,775	1,142,457,300	1,142	
Jul-99	95,402,000	1,598,225	93,803,775	1,125,645,300	1,126	
Aug-99	95,295,000	1,598,225	93,696,775	1,124,361,300	1,124	
Sep-99	105,289,000	1,598,225	103,690,775	1,244,289,300	1,244	
Oct-99	101,073,000	-	101,073,000	1,212,876,000	1,213	
Nov-99	100,204,000	-	100,204,000	1,202,448,000	1,202	
Dec-99	100,600,000	-	100,600,000	1,207,200,000	1,207	
Jan-00	97,034,000	-	97,034,000	1,164,408,000		1,164
Feb-00	95,650,000	-	95,650,000	1,147,800,000		1,148
Mar-00	99,349,000	-	99,349,000	1,192,188,000		1,192
Apr-00	99,271,000	-	99,271,000	1,191,252,000		1,191
May-00	102,775,000	-	102,775,000	1,233,300,000		1,233
Jun-00	103,281,000	-	103,281,000	1,239,372,000		1,239
1997	1,017,825,884	4,794,675	1,013,031,209			
1998	1,088,033,225	19,178,700	1,068,854,525			
1999	1,163,290,000	14,384,025	1,148,905,975			

Source: Col. a = DOD/FEA 1-6, UTI 42-2, UTI 42-2S
Col. b = UTI 10-9

DOD/FEA Test Year Adjustment 8
Test Year Revenues
$(000)

1.	Actual 1999 Intrastate Revenues (Azty1999.xls, Interface-1990 Financials)	$1,163,288
2.	QWEST EOP Adjustment (GAR-S7, Col a)	3,929
3.	QWEST Intrastate Revenues (L3=L1+L2)	1,167,217
4.	Proposed Intrastate Revenues (Attachment 4, p. 1)	1,182,219
5.	Revenue Adjustment (L5=L4-L3)	15,002

DOD/FEA Test Year Adjustment 8
Test Year Revenues
$(000)

Operating Revenue	15,002
Operating Expenses	293
Total Operating Income Taxes	5,913
Net Operating Income	8,796
Rate Base	-
Revenue Requirements	(15,002)

DOD/FEA Test Year Adjustment Summary
$(000)

		U S WEST Test Year (a)	Adj. 1 Customer Operations (b)	Adj. 2 Corporate Operations (c)	Adj. 3 FCC Deregulated Services (d)	Adj. 4 Directory Advertising (e)	Adj. 5 Productivity Adjustment (f)	Adj. 6 Depreciation Adjustment (g)	Adj. 7 Rate of Return Adjustment (h)	Adj. 8 Revenue Adjustment (i)	Adjusted Test Year (j=Sum(a..i))
1.	Adjusted Rate Base	1,422,099	_	_	(9,457)	-	-	(254,769)	-	-	1,157,873
2.	Adjusted Net Operating Income	43,822	12,038	6,870	380	24,238	15,036	37,115	-	8,796	148,295
3.	Current Rate of Return	3.08%	-	-	-	-	-	-	-	-	12.81%
4.	Required Operating Income	154,430	-	-	(1,027)	-	-	(27,666)	(15,284)	-	110,453
5.	Required Rate of Return	10.86%	-	-	-	-	-	-	-1.32%	-	9.54%
6.	Operating Income Deficiency	110,608	(12,038)	(6,870)	(1,407)	(24,238)	(15,036)	(64,781)	(15,284)	(8,796)	(37,842)
7.	Gross Revenue Conversion Factor	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	1.7056	15
8.	Increase in Gross Revenue Requirements	188,654	(20,531)	(11,716)	(2,398)	(41,340)	(25,646)	(110,491)	(26,068)	(15,002)	(64,538)
9.	Three Year Revenue Requirement	(686)	-	-	-	-	-	-	-	-	(686)
10.	Adjustment to Revenue Requirements	13,252	-	-	-	-	-	-	-	-	13,252
11.	Total Increase in Revenue Requirement	201,220	(20,531)	(11,716)	(2,398)	(41,340)	(25,646)	(110,491)	(26,068)	(15,002)	(51,972)
	Source	GAR-S1	Direct Att 6	Direct Att 7	Surrebuttal **Att 1**	Surrebuttal **Att 2**	Direct Att 10	Surrebuttal **Att 3**	Surrebuttal **Att 4**	Surrebuttal **Att 5**	

DEPARTMENT OF THE ARMY
UNITED STATES ARMY LEGAL SERVICES AGENCY
901 NORTH STUART STREET
ARLINGTON, VA 22203-1837

REPLY TO ATTENTION OF

December 13, 1999

Regulatory Law Office
U 4016

Subject: In The Matter Of The Application Of U S West Communications, Inc. A Colorado Corporation, For A Hearing To Determine The Earnings Of The Company, The Fair Value Of The Company For Ratemaking Purposes, To Fix A Just And Reasonable Rate Of Return Thereon And To Approve Rate Schedules Designed To Develop Such Return Docket No. T-01051B-99-0105, Before The Arizona Corporation Commission

Timothy Berg
Fennemore Craig
3003 N Central Ave Suite 2600
Phoenix, Arizona 85012

Dear Mr. Berg:

Enclosed are the 3rd Set of Information Requests to U S West Communications by the United States Department of Defense and All Other Federal Executive Agencies, in the above-referenced proceeding. Please provide a copy of the Responses to Mr. Richard Lee.

Copies have been served on all known parties in accordance with the enclosed Service List.

Sincerely,

Peter Q. Nyce, Jr.
General Attorney
Regulatory Law
Phone: (703) 696-1644
Fax: (703) 696-2960

Before the Arizona Corporation Commission
Docket No. T-01051B-99-0150 Information Requests
Of the Department of Defense
And All Other Federal Executive Agencies
To U S WEST

DOD/FEA 3-1: Please provide gross revenues by month for the year 1999 as they become available in the same format as used in response to DOD 2-1.

CERTIFICATE OF SERVICE

I, Peter Q. Nyce, Jr., certify that I have this day caused this 3rd Set of Information Requests to U S West Communications, on behalf of the Department of Defense and All Other Federal Executive Agencies, to be served on all known parties by sending a copy by either Federal Express or by regular U.S. Mail delivery to those on the "Service List" attached hereto.

Executed December 13, 1999, at Arlington Virginia.

Peter Q. Nyce, Jr.

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BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
Chairman
JAMES M. IRVIN
Commissioner
WILLIAM MUNDELL
Commissioner

IN THE MATTER OF THE APPLICATION OF U S WEST COMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN.	DOCKET NO. T-01051B-99-0105 **OBJECTIONS TO DEPARTMENT OF DEFENSE'S THIRD SET OF INFORMATION REQUESTS TO U S WEST COMMUNICATION, INC.**

Pursuant to the Procedural Order issued in this docket on March 4, 1999, U S WEST Communications, Inc. ("U S WEST") objects to the Department of Defense's ("DOD") Third Set of Information Requests to U S WEST as follows:

<u>Objections to DOD's Third Set</u>

1. U S WEST objects to Information Request DOD/FEA 3-1 on the grounds that it is not reasonably calculated to lead to the discovery of admissible evidence and that it calls for information significantly outside of the test-year established in this matter.

. . . .

. . . .

. . . .

DATED this 21st day of December, 1999.

U S WEST COMMUNICATIONS, INC.
Law Department
Thomas Dethlefs

and

FENNEMORE CRAIG

By Jennifer Prendiville
Timothy Berg
Jennifer Prendiville
3003 N. Central Avenue, Suite 2600
Phoenix, Arizona 85012-2913
Attorneys for U S West Communications, Inc.

ORIGINAL faxed/mailed this 21st day of December, 1999, to:

Peter Q. Nyce, Jr.
Regulatory Law Office
Department of the Army
United States Army Lergal Services Agency
901 North Stuart Street
Arlington, VA 22203-1837

COPY faxed/mailed this 21st day of December, 1999, to:

Constance J. Fitzsimmons
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Arizona Corporation Commission
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Phoenix, Arizona 85007

Maureen Scott
Legal Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Dana Poole

ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

RECEIVED

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AZ CORP COMMISSION
DOCUMENT CONTROL

CARL J. KUNASEK
Chairman
JIM IRVIN
Commissioner
WILLIAM A. MUNDELL
Commissioner

IN THE MATTER OF THE APPLICATION OF U S WEST COMMMUNICATIONS, INC., A COLORADO CORPORATION, FOR A HEARING TO DETERMINE THE EARNINGS OF THE COMPANY, THE FAIR VALUE OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON AND TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN

DOCKET NO. T-01051B-99-0105

SURREBUTTAL TESTIMONY
of
CHARLES W. KING

on behalf of

THE UNITED STATES DEPARTMENT OF DEFENSE
And
ALL OTHER FEDERAL EXECUTIVE AGENCIES

ROBERT N. KITTEL, CHIEF
Regulatory Law Office
Office of The Judge Advocate General
U.S. Army Litigation Center
901 N. Stuart Street, Suite 713
Arlington, Virginia 22203-1837

by

Peter Q. Nyce, Jr.
General Attorney

September 8, 2000

CONTENTS

INTRODUCTION

Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

A. My name is Charles W. King. I am President of the economic consulting firm of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). My business address is 1220 L Street, N.W. Suite 410, Washington, D.C. 20005.

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS DOCKET?

A. I am appearing on behalf of the Department of Defense and all other Federal Executive Agencies ("DOD/FEA").

Q. ARE YOU THE SAME CHARLES W. KING WHO SUBMITTED DIRECT TESTIMONY ON BEHALF OF DOD/FEA IN THIS DOCKET ON JULY 26, 2000?

A. Yes. I am.

Q. DID THAT DIRECT TESTIMONY CONTAIN A SUMMARY OF YOUR EXPERIENCE AND QUALIFICATIONS?

A. Yes. It did.

Q. WHAT IS THE OBJECTIVE OF THIS SURREBUTTAL TESTIMONY?

A. The objective of this surrebuttal testimony is to respond to the challenges to my initial testimony presented by Qwest Witness Peter Cummings on August 21, 2000.

Q. WHAT CHALLENGES DOES MR. CUMMINGS MAKE TO YOUR INITIAL TESTIMONY?

A. Mr. Cummings offers the following challenges to my initial testimony:

1. That my statement that all market returns are comparable to all other market returns is incorrect (page 4),

2. That electric utilities are not comparable in terms of risk to Qwest Corporation (pages 5 and 14).

3. That I underestimated the dividend yield for Verison (page 7),

4. That I inappropriately included a DCF return analysis for the pre-merger US WEST (page 8),

5. That I inappropriately dismissed the historical risk premium model as flawed (page 9), and

6. That I failed to provide adequate allowance for stock issuance expense (page 12).

1. <u>COMPARABILITY OF MARKET RETURNS</u>

Q. WHAT IS MR. CUMMINGS' CRITICISM WITH RESPECT TO YOUR STATEMENT THAT ALL MARKET RETURNS ARE COMPARABLE WITH ALL OTHER MARKET RETURNS?

A. Mr. Cummings states that the obvious variation in earnings-price ratios proves that all market returns are not comparable with all other market returns.

Q. WHAT IS YOUR RESPONSE TO THIS CHALLENGE?

A. Mr. Cummings either does not, or chooses not to understand my statement at the top of page 5 of my direct testimony. There, I argue that investors assess the likely returns from each stock and adjust the price they are willing to pay according to that assessment. That assessment considers three things: the dividend yield, the likely growth in earnings, and the assurance of that earnings growth. Earnings-price ratios differ because some companies have higher dividend yields than others. Earnings price ratios also differ because some companies' earnings are predicted to increase at a faster rate than others. Finally, earnings-price ratios differ because there is greater confidence in the rate of earnings growth for some companies than for others. The fact remains, however, that the market price of <u>all</u> stocks reflects the consensus of the investing community as to the comparability of yield, earnings growth and earnings certainty. That is my simple point.

2. COMPARABLE COMPANIES

Q. WHAT IS MR. CUMMINGS' CHALLENGE WITH RESPECT TO COMPARABLE COMPANIES?

Q. Mr. Cummings accuses me of biasing the results of my analysis by using electric utilities as comparable companies to US WEST.[1] He argues that his selection of 30 companies from a variety of industries is more comparable to US WEST in terms of risk. He supports this position by comparing the betas of the electric companies with those of the three surviving non-US WEST Bell holding companies.

Q. WHAT IS YOUR RESPONSE TO THIS CRITICISM?

A. The issue of comparable companies is always a contentious one in rate-of-return analyses. It is clarified by focusing on the specific business activities for which we are attempting to find comparable risk. In the present case, the business activities under study are the intrastate landline telephone services of US WEST in Arizona. Those services display a number of salient characteristics that are not shared by other activities of US WEST or the other Regional Bell Holding Companies ("RBHCs"). First, there is a high degree of market power, which if unchecked by regulation, would permit US WEST to earn monopoly profits. Second, there is regulation, which in Arizona continues to be closely cost-based. In this regard, Arizona intrastate regulation differs from interstate access charge regulation, where prices have been decoupled from costs and the carriers are able to earn high profits without fear of consequent forced rate reductions. Arizona intrastate services also differ from the wireless operations of the respective telephone companies, which are not regulated with respect to price and which face considerable competition from other suppliers.

---

[1]Throughout this surrebuttal, I refer to US WEST, even though the company has changed its name to Qwest, in order to distinguish the pre-merger company from the consolidated post-merger company. Qwest Communications, Inc., the post-merger company, is a far riskier enterprise than was US WEST, and more specifically, US WEST's Arizona intrastate operations.

While Mr. Cummings may have a point that electric utility companies are less risky than telephone companies (US WEST possibly excluded), the activities of electric utilities are quite similar to the activities subject to this rate-of-return analysis. As I point out in my direct testimony, electric utilities have geographically defined franchise areas, are subject to regulation, and are currently experiencing growing competition and considerable industry restructuring. This is a good description of US WEST's Arizona intrastate operations. I should point out further that electric utilities continue to be subject to rate base/rate-of-return regulation similar to that applied to US WEST's Arizona operations and unlike that applied to interstate access services and the intrastate services of many of the other RBHCs. For this reason, I again assert that electric utilities are similar in their risk characteristics to US WEST's Arizona intrastate operations.

Mr. Cummings purports to rebut my use of electric utilities by comparing their composite beta of .49 with a beta for his telephone industry group of .84. Notably, Mr. Cummings fails to mention that US WEST's pre-merger beta was also .49, as reported on page 32 of my direct testimony.

Q. IS MR. CUMMINGS' COMPOSITE INDUSTRY GROUP COMPARABLE IN RISK TO US WEST'S ARIZONA INTRASTATE OPERATONS?

A. No, at least as measured by betas. Exhibit CWK-01 compares Zack's betas with the rates of return calculated by Mr. Cummings for the 17 of the 20 "Comparable Risk Companies" in exhibits PCC-6 in his original testimony and 29 of the 30 PCC-04 in his supplemental testimony.[2]

[2]Two companies are dropped from page 1 because of mergers; Brown Foreman is dropped from both exhibits because no beta reports are available from Zack's.

Page 1 of my exhibit shows that the companies presented in Mr. Cummings' initial testimony cluster into two quite distinct groups. The four electric utilities have, quite unsurprisingly, low betas and low rates of return. All of the unregulated service and manufacturing companies have high return requirements, even though their betas stretch from .45 to almost 1.20.

Page 2 of Exhibit CWK-01 shows the same information for the companies presented in Mr. Cummings' supplemental testimony. Again, the utilities cluster at the low end of the scales for both beta and equity cost. The non-utilities display higher betas but no clear relationship between beta and equity cost.

This last observation is the most relevant. Page 3 replicates the data in page 2 just for the non-utility companies. It also presents the results of my effort to establish a correlation between beta and rate of return. There is none: the R^2 is .00001. This result is in direct contradiction to the basic precept of the Capital Asset Pricing Model ("CAPM") that beta, the measure of undiversifiable risk, determines the return requirements of each company relative to the overall market. It suggests that the CAPM, as applied to individual companies, represents the triumph of theory over evidence.

As applied to portfolios of companies, however, beta appears to have some value. The portfolio of electric companies clearly has less risk than that of industrial enterprises. As I noted earlier, the general riskiness of electric utilities resembles that of US WEST's Arizona intrastate operations, and for that reason the earnings requirements of those companies represent the better indicator of US WEST's equity cost than an average for a broad mix of utilities and industrial companies.

3. VERIZON DIVIDEND YIELD

Q. WHAT IS MR. CUMMINGS' CHALLENGE WITH REGARD TO VERIZON'S DIVIDEND YIELD?

A Mr. Cummings states that I committed an error in my calculation of Verizon's dividend yield. I indicated that the dividend would be $.20 for a yield of 0.36 percent. Mr. Cummings states that Verizon's going-forward dividend is $1.54, for a yield of 2.81 percent.

Q. WHERE DID YOU GET YOUR $.20 DIVIDEND ESTIMATE?

A. The actual number was derived from an estimate of $.047 per quarter as reported on July 18, 2000 by Yahoo. As of July 11, 2000, Zack's Investment Research reported no dividend whatever for Verizon.

Q. ARE THESE THE DIVIDEND ESTIMATES CURRENTLY BEING REPORTED?

A. No. All of the investment services are currently reporting $1.54 as the annual dividend. Apparently, my sources preceded the establishment of a dividend policy by Verizon. Mr. Cummings' revision is therefore appropriate.

4. INCLUSION OF US WEST IN DCF ANALYSIS

Q. WHAT IS MR. CUMMINGS' OBJECTION TO YOUR INCLUSION OF US WEST IN YOUR DCF ANALYSIS?

A. Mr. Cummings argues that prior to the merger with Qwest, US WEST was trading as a derivative of Qwest, was significantly influenced by arbitrage trading relative to pricing of the merger and was influenced by speculation about further business combinations affecting both US WEST and Qwest. For these reasons, Mr. Cummings believes it is not appropriate to include US WEST in the DCF analysis.

Q. WHAT IS YOUR RESPONSE TO THESE COMMENTS BY MR. CUMMINGS?

A. I suspect that the cause of Mr. Cummings' dislike of US WEST as a subject of DCF analysis is the low value of the results, not the impropriety of the inclusion. The DCF analysis that I provided was derived from data that predated June 30, 2000, which was the date on which the regulatory approvals for the merger with Qwest were finally received. During those earlier periods, the merger could not be assumed. The Zack's consensus earnings forecasts that I used were for US WEST, the pre-merger company, and not for the merged Qwest. It is these very low earnings forecasts that account for the low DCF results for US WEST.

Further demonstration that the impending merger is not responsible for the low US WEST results is provided in exhibit CWK-02, which is a portion of testimony I drafted for filing on October 25, 1999 in this case.[3] This draft testimony presents my development of the "classic" DCF formulation based on data that predated or closely followed the July 18, 1999 announcement date of the merger with Qwest. These results would have been even less influenced by the pending merger than those in my current testimony. Nevertheless, the same pattern appears: US WEST's equity return is much lower than that of the other RBHCs, principally due to the lower earnings growth expectations.

Q. WHY WOULD US WEST HAVE A LOWER EARNINGS REQUIREMENT THAN THE OTHER RBHCs?

A. A likely explanation is provided by Mr. Cummings himself. In his rebuttal to Staff witness Stephen Hill, Mr. Cummings provides the following proportions of revenue provided by local service:

RBHC Service Makeup[4]

Company	% Local Service
Bell Atlantic	55%
BellSouth	43%
SBC	39%
US WEST	59%

[3]The filing was postponed due to the pendency of findings with regard to depreciation rates.

[4]Rebuttal Testimony of Peter C. Cummings, pages 19, 20, cited to Value Line Investment Survey, July 7, 2000.

On Exhibit CWK-03, I have calculated the 1999 local service proportion of Verizon's revenue as 36 percent, based on consolidated historical information distributed by the newly merged company in August 2000.

US WEST has much the highest proportion of local service revenue of any of the RBHCs. Local Service is the most secure, least risky, but also the slowest growing segment of the telephone market. US WEST's heavy concentration in local service would account for the low growth expectations of investment analysts and for the generally lower return requirements demanded by investors.

5 <u>HISTORICAL RISK PREMIUM MODEL</u>

Q. WHAT IS MR. CUMMINGS' CHALLENGE WITH RESPECT TO YOUR STATEMENTS REGARDING THE HISTORICAL RISK PREMIUM MODEL?

A. Mr. Cummings states that finance theorists and finance practitioners have consistently advocated the use of historical data to estimate the expected market risk premium over the risk free rate obtained from investment in government securities. He then quotes from two textbooks that say that securities analysts extrapolate past risk premiums to future periods.

Q. WHAT IS YOUR RESPONSE TO THESE COMMENTS?

A. It is one thing to say that there is a premium for equity risk over government debt and that historical differences in returns are an indicator of that premium. It is quite another matter to take the 72-year average difference in achieved monthly returns to stocks and government bonds, add it to the current Treasury bond yield, and claim to have estimated the currently required return to equity. Mr. Cummings overlays a specious mathematical calculation on rather simple principle of finance, which is that there is (usually) a greater risk associated with equity investment relative to government debt.

Mr. Cummings does not address, let alone rebut, the conceptual challenges I have raised against his historical risk premium calculation, nor does he attempt to refute my demonstration that the historical risk premium calculation he uses is statistically worthless as a predictor of future risk premiums.

6. FLOTATION COSTS

Q. WHAT IS MR. CUMMINGS' CHALLENGE TO YOUR COMMENTS ON FLOTATION COSTS?

A. Mr. Cummings quarrels with my calculation of flotation costs and the amount of recovery that would be allocated to Arizona ratepayers. First, he states that $55 million is not the appropriate amount of flotation costs; rather, the figure is $166.7 million. Then, he states that stock issuance costs are applicable only to the equity financing of US WEST Communications, apparently in contradiction to my application of the return differential to the parent company's capitalization. Finally, he claims that his flotation cost adjustment would generate an Arizona allowance of about $2 million annually.

Mr. Cummings goes on to comment on my proposal that any stock issuance costs be amortized directly to rates, rather than included as an additive to the rate of return. He concludes that it would be inappropriate to burden ratepayers in any one period of time for the issuance of stock that is perpetual.

Q. WHAT IS YOU RESPONSE TO MR. CUMMINGS COMMENTS REGARDING YOUR CALCULATION?

A. First, the $55 million I identified in my initial testimony is correctly labeled as the stock issuance cost since 1984 as reported by Mr. Cummings in his PCC-10.[5] The $166.7 million referred to by Mr. Cummings includes $112.7 million in pre-1984 issuance costs. This would have been flotation cost for selling the stock of AT&T prior to the breakup of the Bell System. While that cost has been allocated to US WEST, I believe it inappropriate to burden present-day ratepayers with the issuance costs of stock in an extinct company that was found to be in violation of the anti-trust laws.

It is not true that stock issuance costs pertain only to the subsidiary company, US WEST Communications, Inc. Stock issuance costs are not incurred by wholly-owned subsidiaries; they are incurred by the parent, which is the entity that sells stock to the public.

Finally, Mr. Cummings' calculation of $2 million in Arizona-related flotation cost collections annually does not refute my statement that this allowance grossly overcompensates the Company for its experienced flotation costs. If US WEST's

[5]The actual number from Mr. Cummings' exhibit is $55.5 million, but a small amount of that number must be allocated to the USW Media Group.

Arizona equity capitalization is slightly over $1 billion,[6] and if the Company's December 31, 1995 paid in equity capital was $8.228 billion,[7] then Arizona accounts for no more than 12 percent of the total — probably much less. Twelve percent of $55 *million* is $660,000. Amortized over 15 years, the annual revenue requirement for this cost would be $44,000, or 2 percent of the $2 million allowance Mr. Cummings proposes to collect annually through an upward adjustment in the rate of return.

Q. WHAT IS YOUR RESPONSE TO MR. CUMMINGS COMMENTS ON THE RELATIVE DESIRABILITY OF AMORTIZING FLOTATION COSTS

A. As I have just demonstrated, the costs of stock flotation are negligible when converted into an annual amortization, even using a relatively short 15-year period. However, the Company is entitled to recover these costs if it incurs them, and an amortization would ensure that recovery. A properly quantified adder to the rate of return would be so small as to be lost in the rounding. For this reason, I recommend that flotation costs, if they are incurred, be amortized as an explicit item in the revenue requirement calculation.

Q DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?

A. Yes. It does.

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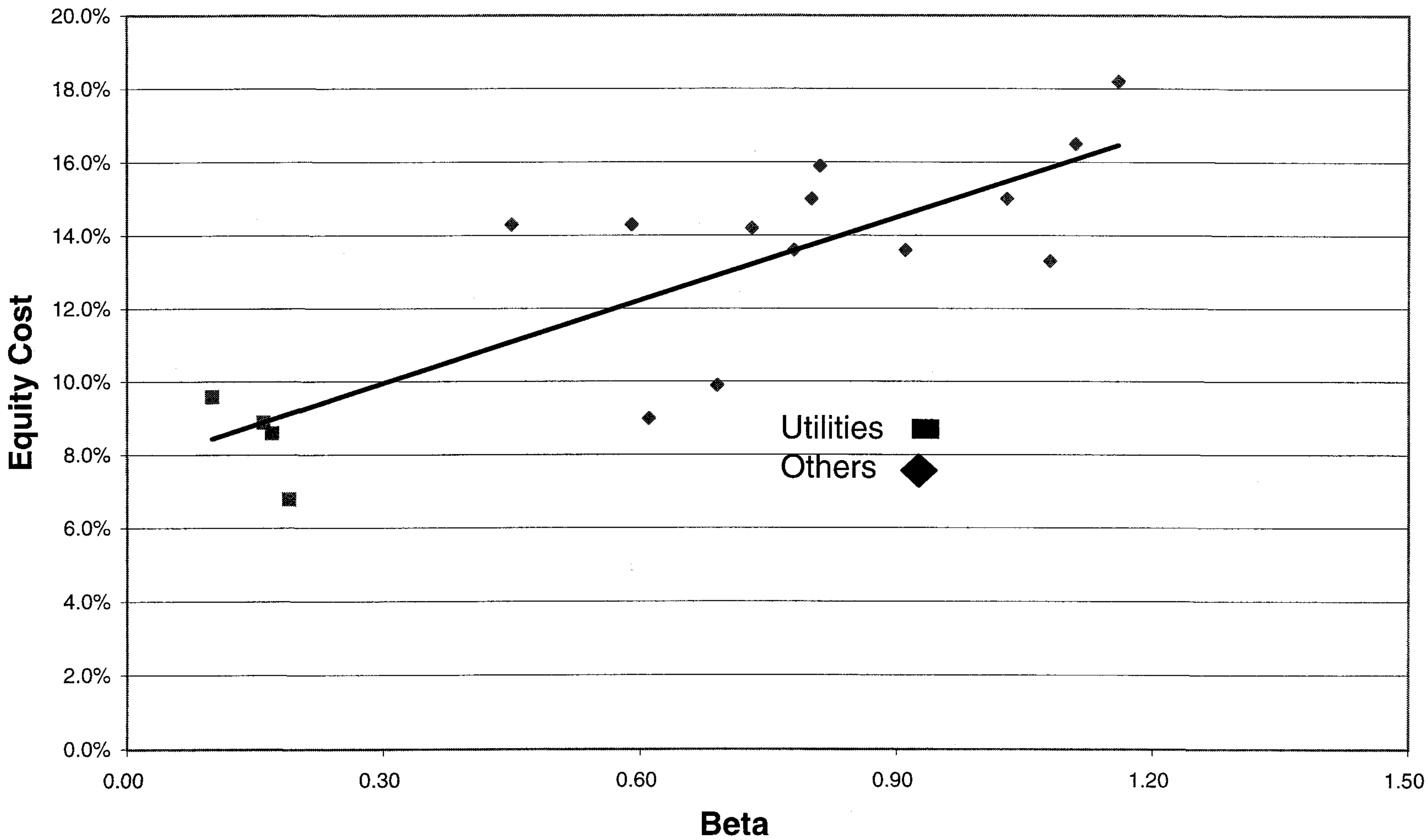
[6]Cummings Rebuttal Testimony at page 12. Mr. Cummings refers to an Exhibit PCC -02 as the source of this number, but it is not to be found in the exhibit with that label.

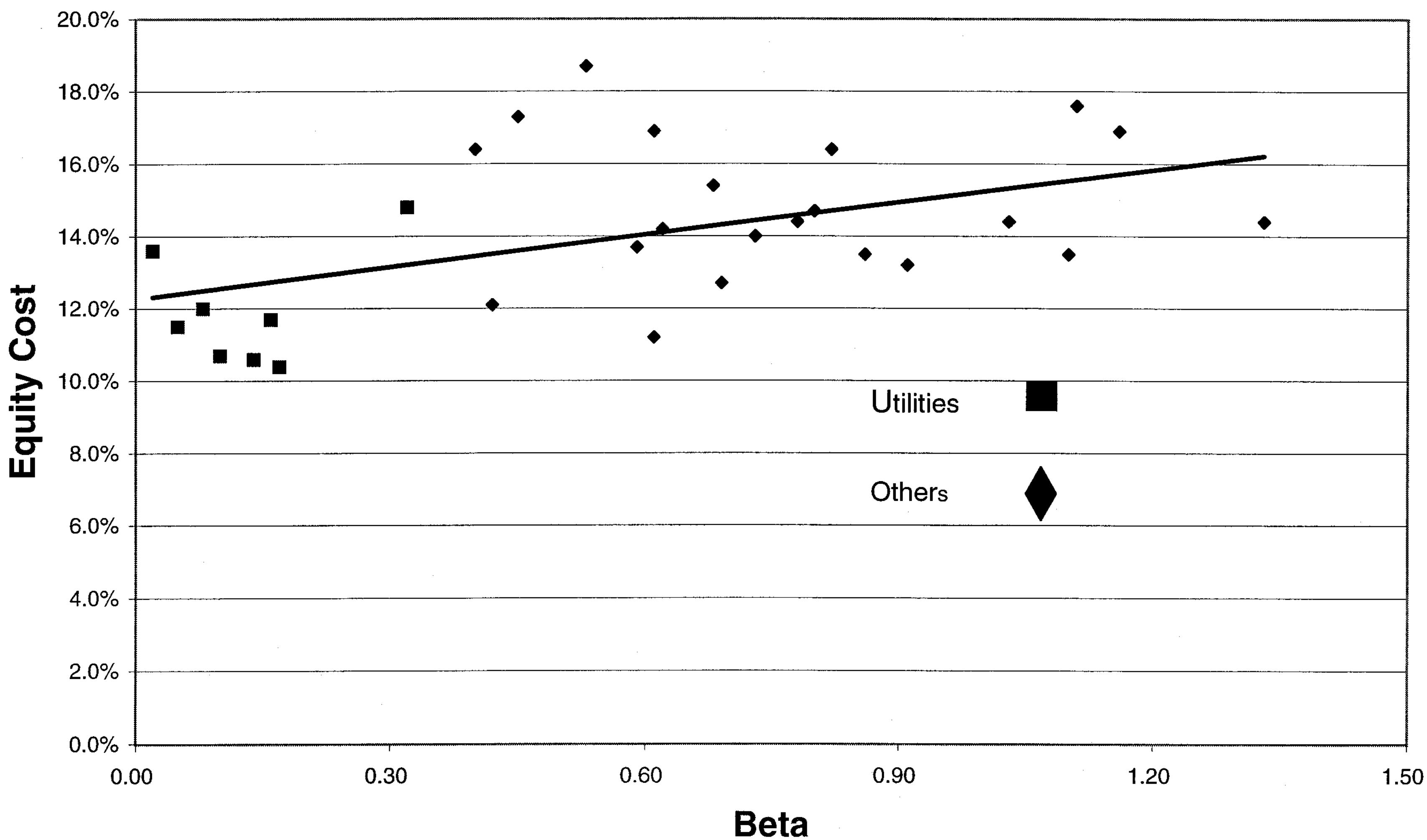
[7]Exhibit PCC-10

Beta vs Equity Cost
USW "Comparable Risk" Index 1/8/99



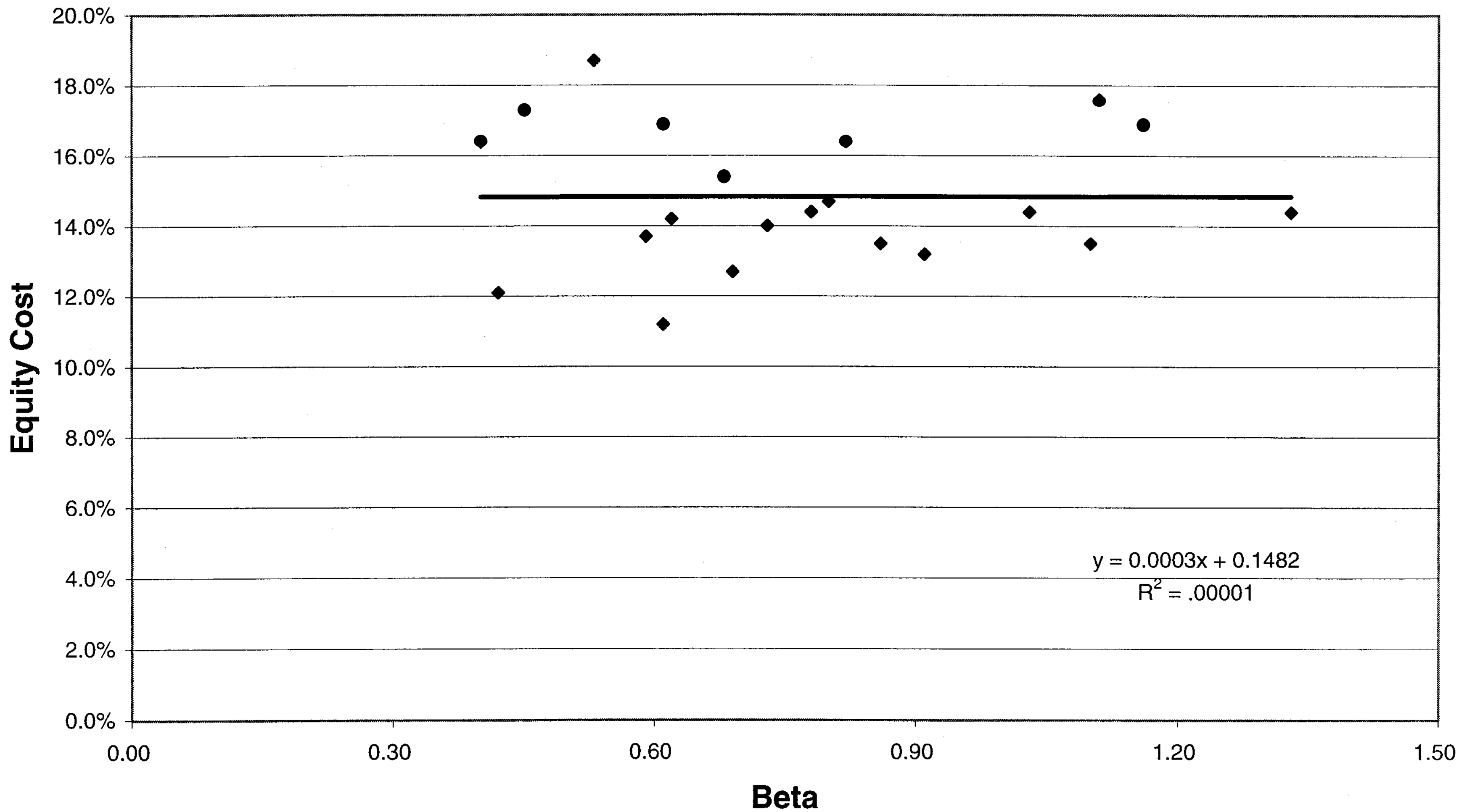
Sources: Betas from Zacks Research 8/28/00
Equity Cost from Exhibit PCC-06

Beta vs Equity Cost
USW "Comparable Risk" Index 5/3/00



Sources: Betas from Zacks Research 8/28/00
Equity Cost from Exhibit PCC-04

Beta vs Equity Cost
USW "Comparable Risk" Index 5/3/00
Excluding Utilities



Sources: Betas from Zacks Research 8/28/00
Equity Cost from Exhibit PCC-04

Q. HOW WILL YOU IDENTIFY THE MARKET-DETERMINED RATE OF RETURN TO THE EQUITY CAPITAL INVESTMENT IN US WEST'S ARIZONA OPERATIONS?

A I shall first apply the Discounted Cash Flow ("DCF") procedure, which I consider to be the most accurate test of a market return. I shall then consider the Capital Asset Pricing Model, discuss its conceptual and measurement problems, and assess its value in measuring the relative riskiness of different companies. In the course of this discussion, I will comment on the analysis presented by US witness Peter Cummings and explain why his proposed equity return, which is 200 basis points (2.0%) higher than my recommendation, is inappropriate for the equity of US WEST.

A. DISCOUNTED CASH FLOW PROCEDURE

Q. PLEASE DESCRIBE THE DISCOUNTED CASH FLOW PROCEDURE.

A. The basic premise of the Discounted Cash Flow (" DCF") procedure is that the market establishes the price of each stock at the discounted present value of all future flows of cash that investors expect from purchasing that stock. The discount rate that equates those future cash flows with the market value of the stock is the investors' required rate of return.

The DCF approach is usually represented by the following formula:

$$k = {}^{d}/_{P} + g$$

where k = required rate of return
d = dividend in the immediate period
P = market price
g = expected growth rate in dividends

While the DCF method is usually presented in mathematical notation format (as above), it can also be described in narrative fashion. The formula says that the return which any investor expects from the purchase of a stock consists of two components. The first is the immediate cash flow in the form of a dividend. The second is the prospect for future growth in dividends. The sum of the rates of these two flows, present and future, equals the return that investors require. Investors adjust the price they are willing to pay for the stock until the sum of the dividend yield and the annual rate of expected future growth in dividends equals the rate of return they expect from other investments of comparable risk. The DCF test thus determines what the investing community requires from the company in terms of present and future dividends relative to the current market price.

1. GROWTH RATE

Q. HOW CAN THE "g" OR GROWTH FACTOR IN THE DCF FORMULA BE IDENTIFIED?

A According to the DCF theory, the relevant measure of "g" should be the growth in dividends. Dividends, however, are largely a function of management discretion, and they do not necessarily reflect the underlying driver of earnings. Simply by changing the dividend payout ratio, a company's management can create a rate of dividend growth that is unsustainable. For this reason, I believe that earnings per share ("EPS") is the most reliable indicator of the "g" factor.

I agree with Mr. Cummings that the expectations of investment analysts are probably the most reliable basis upon which to estimate the "g" factor in the DCF formula. Mr. Cummings uses the Institutional Brokers Estimate System ("I/B/E/S"). I have added the somewhat broader survey of investment analysts by Zacks Investment Research, Inc., which includes retail as well as institutional brokers.

Q. WHAT ARE THE "g" ESTIMATES BASED ON INVESTMENT ANALYSTS' FORECASTS?

A. The two sets of forecasts and their averages are as follows:

Table 1
Forecast 5-Year RBHC Earnings Per Share Growth Rates

Company	I/B/E/S	Zacks	Average
Ameritech	8.95%	8.56%	8.76%
Bell Atlantic	10.20%	9.34%	9.77%
BellSouth	10.24%	10.08%	10.16%
SBC	12.00%	11.74%	11.87%
US WEST	6.90%	6.30%	6.60%

2. DIVIDEND YIELD

Q. HOW DO YOU DERIVE THE DIVIDEND YIELD PORTION OF THE DCF FORMULA?

A. The dividend yield can be calculated as the next year's dividend divided by a recent average of the price of the stock. The resultant yield should reasonably match the dividend yields shown in the financial reporting services.

Q. HOW DO YOU FORECAST THE NEXT YEAR'S DIVIDEND?

A. Conventional procedure is to compute the next year's dividend as the most recent dividend annualized plus one half the analysts' prediction of the long-term growth rate in earnings per share, as shown in Table 1 above. This formulation yields the following estimates dividend forecasts:

Table 2
RBOC Dividends, Forecast for 1999

Company	Dividend	1/2 Growth	Forecast
Ameritech	$1.27	4.38%	$1.33
Bell Atlantic	1.54	4.88%	1.62
BellSouth	0.76	5.08%	0.80
SBC Communications	0.98	5.94%	1.38
US WEST	2.14	3.30%	2.21

The use of these forecasts in the dividend yield calculation is conservative, that is, it likely overstates the dividend in the coming year. As I will demonstrate shortly, all five RBHCs have been reducing their dividend payout ratios in recent years. That is, they have been increasing their dividends at a much slower rate than their experienced increase in earnings. If this trend continues into the coming year, then the use of predicted growth in earnings per share overstates the likely growth in dividend.

Q. HOW DO YOU IDENTIFY THE DENOMINATOR IN THE DIVIDEND YIELD CALCULATION, THE RECENT PRICE OF THE STOCKS?

A. Some judgement is required to establish a set of price observations that capture the investing public's current perception of value while at the same time reflecting some stability in the market. Given the fluctuations of the markets, a price observation for a single day, week, or even month runs the risk of becoming obsolete in a very short time. Market fluctuations also mean that the use of monthly highs and lows may exaggerate the effect of some of the sharp drops and rises that the markets have experienced recently.

I therefore recommend an average of the closing prices for all trading days during the most recent three months. On this basis, the dividend yield for the five RBHCs can be calculated as follows:

Table 3
RBOC Dividend Yield

Company	Dividend	Price[1]	Yield
Ameritech	$1.33	$68.57	1.94%
Bell Atlantic	1.62	63.03	2.57%
BellSouth	0.80	46.01	1.74%
SBC Communications	1.38	52.96	2.61%
US WEST	2.21	55.54	3.98%

Q. MR. CUMMINGS CLAIMS THAT IT IS APPROPRIATE TO COMPOUND THE QUARTERLY DIVIDENDS IN ORDER TO CALCULATE THE ACTUAL DIVIDEND YIELD. DO YOU AGREE?

A. No. Mr. Cummings argues that the yield from quarterly dividends is greater than the simple summation of those dividends because investors have the opportunity to earn return during the portion of the year following the receipt of each dividend. Thus, the yield on the first quarter's dividend is supplemented by that dividend's earnings power during the three remaining quarters that the investor

[1]Average of closing prices July 7, 1999 - October 7, 1999 as reported by Yahoo Financial Data.

holds it. The second quarter's dividend earns additional return during the following two quarters. The third dividend generates a quarter of a year's return.

All this is true, but it has nothing to do with the cash dividends that must be generated by the dividend-issuing company to satisfy investors' requirements. Investors' ability to earn on quarterly dividends is quite outside of the cash flow from the company: it is achieved by taking that cash flow and reinvesting it elsewhere. The cash flow from the company does not need to be supplemented.

3. CLASSIC DCF CALCULATION

Q. WHAT ARE THE RESULTS OF YOUR DCF ANALYSIS?

A. The indicated rates of equity return using this calculation are as follows:

Table 4
RBOC Equity Return "Classic" DCF Calculation

Company	Dividend Yield	Growth	Return
Ameritech	1.94%	8.76%	10.70%
Bell Atlantic	2.57%	9.77%	12.34%
BellSouth	1.74%	10.16%	11.90%
SBC Communications	2.61%	11.87%	14.48%
US WEST	3.98%	6.60%	10.58%
Average, All RBOCs			12.00%

Q. HOW WOULD YOU CHARACTERIZE THESE RESULTS?

A. The sum of the dividend yield and the growth rate as I have developed them is often referred to as "classic" DCF calculation. The Federal Communications Commission ("FCC") recently concluded tentatively that this method should be given the greatest weight in determining the rate of return to equity.[2] I agree with that conclusion.

---

[2]*Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking*, CC Docket No. 98-166, October 5, 1998, ¶ 26.

Verizon Communications
Consolidated 1999 Revenues

Local Services	$21,145	36.34%
Network Access	13,381	
Long Distance	3,253	
Other Domestic Teleco	5,204	
Domestic Wireless	7,658	
International	1,957	
Information Services	4,086	
Other	1,510	
Total	$58,194	

Source: Verizon Communications:
Pro Forma Historical Financial Information
August, 2000

RIGINAL

<u>CERTIFICATE OF SERVICE</u>

I, Peter Q. Nyce, Jr., certify that I have this day caused the Surrebuttal Testimony of Richard B. Lee, and Surrebuttal Testimony of Charles W. King, on behalf of the Department of Defense and All Other Federal Executive Agencies, to be served on all known parties by sending a copy by either Federal Express or by regular U.S. Mail delivery to those on the "Service List" attached hereto.

Executed September 7, 2000, at Arlington Virginia.

Peter Q. Nyce, Jr.

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